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No. 84-1307

In the Supreme Court of the United States

OCTOBER TERM, 1984

FORTUNE ODEND'HAL, JR., AND
GLORIA P. ODEND'HAL, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

ANN B. DURNEY
MICHAEL J. ROACH
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

12 pp

QUESTIONS PRESENTED

1. Whether the court of appeals correctly sustained, as not clearly erroneous, the Tax Court's finding that the face amount of nonrecourse notes issued to finance petitioners' purchase of property unreasonably exceeded the property's fair market value at the time petitioners acquired it.

2. Whether the court of appeals correctly disallowed petitioners' claimed interest and depreciation deductions based on a finding that the nonrecourse notes described above did not constitute genuine indebtedness.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 39a-49a) is reported at 748 F.2d 908. The opinion of the Tax Court (Pet. App. 1a-38a) is reported at 80 T.C. 588.

JURISDICTION

The judgment of the court of appeals was entered on November 20, 1984. The petition for a writ of certiorari was filed on February 14, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners are seven of the ten investors in a real estate tax shelter that was put together by Charles Fairchild, a real estate syndicator and developer (Pet. App. 11a-16a). The tax-shelter property consisted of a warehouse and food-processing facility located in Cincinnati, Ohio,

and leased to the Kroger Company (*id.* at 3a-4a, 10a). Pursuant to the offering circular, petitioners purchased the buildings and the benefits of the Kroger lease for a stated price of $4 million. Of that sum, $80,000 was paid in cash and $3,920,000 was represented by nonrecourse notes (*id.* at 10a). The sales transaction did not include the land, which was rented to petitioners under a long-term ground lease (*id.* at 10a-11a). The offering circular included a projection showing that the investors, as a group, could expect to recognize tax losses ranging from $538,468 in the first year down to $214,034 in the fifteenth year. Assuming a 50% tax bracket, the resulting tax savings would be sufficient to convert a negative cash flow from the investment into a positive after-tax cash flow in each of the 15 years for which the projection was made (*id.* at 14a).

In December 1972, each petitioner furnished his allocable share of the $80,000 cash downpayment and seven months' prepaid interest on the nonrecourse notes (Pet. App. 15a). However, the documents transferring title to the property were not prepared and signed until December 1973, and they were not recorded until 1979 (*id.* at 10a-11a, 15a). On their federal income tax returns for 1973 and subsequent years, each petitioner deducted his allocable share of the interest and depreciation, based upon the assumption that the $3.92 million nonrecourse notes represented genuine indebtedness and that face value of that debt was properly includable in the depreciable basis of the property.

2. The Tax Court found that the $4 million stated purchase price unreasonably exceeded the fair market value of what petitioners bought, that the nonrecourse notes did not represent genuine indebtedness, and that petitioners accordingly were not entitled to the interest and depreciation deductions they claimed (Pet. App. 19a, 37a). In making these determinations, the Tax Court relied on expert testimony and prior sales (*id.* at 23a-28a). The Commissioner's

experts appraised petitioners' "leased fee interest" by discounting the stream of future Kroger lease rentals to present value and by adding to that sum the discounted value of petitioners' reversionary interest (*id.* at 24a-26a). Although the two experts used slightly different discount rates and a different method of calculating the value of the reversion, each concluded that the interests petitioners purchased were worth somewhat less than $2 million in 1972 (*id.* at 25a-26a). Petitioners presented no expert testimony from a qualified real estate appraiser that the property was worth $4 million as they claimed (*id.* at 44a).

The Tax Court then analyzed the evidence of prior sales that petitioners relied on to support their contention that the property was worth $4 million in 1972. The court found that the property had been sold by Kroger to a life insurance company for $5 million in 1951, by the life insurance company to Fairchild for $2.67 million on April 1, 1967, by Fairchild to the Burwell group (a group of tax-shelter investors) for $5 million on May 1, 1967, and by the Burwell group back to Fairchild for $2.04 million in April 1973 (Pet. App. 5a-9a, 30a). The court concluded that these prior sales — to the extent they were conducted recently and at arm's length — tended to corroborate the testimony of the Commissioner's experts that the property was worth no more than $2 million in 1972 (Pet. App. 30a-31a). The court found that the 1951 sale was of limited relevance in determining the property's 1972 value (*id.* at 29a-30a). And it found that the $5 million price tag for the May 1, 1967, sale was "incredible" as an indicator of fair market value, noting that Fairchild had purchased the property 30 days earlier for only $2.67 million and finding "nothing in the record to indicate how such a dramatic change could have occurred within a few weeks" (*id.* at 30a-31a). The court concluded that the $5 million sales price had been artificially inflated by Fairchild, the syndicator and seller of the property, for

the purpose of allowing tax-shelter investors to claim exaggerated deductions, and that the sale should accordingly be disregarded (*ibid.*).

The court of appeals unanimously affirmed. It sustained as "not clearly erroneous" the Tax Court's finding that the property was worth no more than $2 million when petitioners purchased it (Pet. App. 43a-46a). And it affirmed the Tax Court's finding that, "because of the wide discrepancy between [the] market value [of the property] and the [face] amount of the nonrecourse notes[,] the latter did not represent genuine indebtedness" capable of supporting petitioners' claimed interest and depreciation deductions (*id.* at 40a, 46a-49a). The court of appeals explained that where (as here) the nonrecourse debt unreasonably exceeds the property's fair market value, the borrower has no economic incentive to repay the loan and, accordingly, has no investment in the property for federal tax purposes (*id.* at 49a).

ARGUMENT

The decision below is correct. Contrary to petitioners' contention, it does not conflict with any decision of this Court or of any other court of appeals. The questions presented are essentially factual and do not warrant further review.

Petitioners argue (Pet. 5-7) that the courts below erred in determining that the 1972 fair market value of the tax-shelter property was not more than $2 million. This argument in turn is based on the contention that those courts improperly disregarded the $5 million purported sales price of the May 1, 1967, transfer. While it is true that the parties to that transfer testified that it "was conducted at arm's length" (Pet. 5, 6) — it was in the obvious economic interest of all parties to the transaction so to testify — the Tax Court found their testimony "incredible" (Pet. App. 31a) in light of the objective facts and the court of appeals held that this

finding was not clearly erroneous (*id.* at 46a). There is no reason for this Court to review that finding of fact.[1]

Petitioners also assert (Pet. 8) that, even if the property was not worth $4 million, the evidence at trial showed that it was worth between $1.7 million and $2 million; they contend that they should be entitled at least to deduct interest and depreciation on that amount, rather than having their deductions limited (as the courts below held) to the amount of income they derived from their investment. See Pet. App. 19a, 49a. This argument misconstrues the holdings below. Neither the Tax Court nor the Fourth Circuit made any finding as to the actual fair market value of the tax-shelter property. Rather, they found that the property's value did not exceed $2 million, that the $3.92 million nonrecourse debt thus unreasonably exceeded the property's value, and that the nonrecourse notes thus did not constitute genuine indebtedness (Pet. App. 37a, 46a-49a). Because the nonrecourse notes were not genuine debt, they could yield no interest deductions and they were not properly includable in the property's basis for depreciation purposes. *Ibid.* The lower courts' conclusions to this effect reflect well-settled tax principles. See, *e.g.*, *Brannen* v. *Commissioner*, 722 F.2d 695 (11th Cir. 1984); *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045, 1049 (9th Cir. 1976).[2]

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[1]Since the determination of fair market value is factual, there is no merit to petitioners' contention (Pet. 5-6) that the decision below conflicts with *Estate of Kaplin* v. *Commissioner*, 748 F.2d 1109 (6th Cir. 1984). The Sixth Circuit there concluded that the Tax Court had given inadequate weight to an arm's-length sale of certain property two years after the valuation date. The instant case plainly does not conflict with *Estate of Kaplin*, since both courts below found that the May 1, 1967, sale, five years before the valuation date, was not conducted at arm's length.

[2]The Tax Court (Pet. App. 19a) did permit petitioners to claim deductions up to the amount of income they derived from the property. Cf. I.R.C. § 183(b)(2) (providing that, in the case of activities not

Finally, petitioners err in contending (Pet. 10) that the decisions below conflict with *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), or *Commissioner* v. *Tufts*, 461 U.S. 300 (1983). The sale-and-leaseback arrangement at issue in *Frank Lyon Co.* did not involve nonrecourse financing, and the debt as to which deductions were allowed was genuine debt (435 U.S. at 576-577). In *Tufts*, which did involve nonrecourse debt, the taxpayers had previously taken depreciation deductions premised on the inclusion of that debt in the property's basis, and the question was whether their discharge from the debt should be included in their "amount realized" for purposes of computing their gain or loss on the property's sale (461 U.S. at 302-303). This Court held that inclusion of the nonrecourse debt in the sale proceeds under those circumstances was required, reasoning that to permit the taxpayers to take advantage of the nonrecourse debt in claiming deductions, then ignore it in computing gain, would be "asymmetrical[ ]" (461 U.S. at 313). Here, by contrast, the question is whether the nonrecourse debt should be included in basis at the threshold, and the courts below held that it should not be included because it was not real debt. See Treas. Reg. § 1.1001-2(a)(3). Given that finding of fact, nothing in *Tufts* could be construed to require a different result.

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engaged in for profit, there shall be allowed deductions which would be allowable if the activity were engaged in for profit, "* * * but only to the extent [of] the gross income derived from such activity * * *"). The Tax Court, however, did not determine how such deductions should be apportioned as among depreciation, interest, taxes and other expenses, and the court of appeals (Pet. App. 49a) remanded for a computation along those lines. To the extent petitioners seek here to present questions as to the exact depreciation deduction to which they may be entitled, their petition is premature.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

REX E. LEE
Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

ANN B. DURNEY
MICHAEL J. ROACH
Attorneys

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